



## An amalgamated company cannot claim depreciation on the assets acquired in the scheme of amalgamation including goodwill, more than which is permitted to the amalgamating company

### Background

Recently, the Bangalore Bench of the Income-tax Appellate Tribunal (the Tribunal) in the case of United Breweries Ltd.<sup>1</sup> (the taxpayer) dealt with the claim of depreciation on goodwill. The Tribunal held that the taxpayer being the amalgamated company cannot claim depreciation on the assets acquired in the scheme of amalgamation more than the depreciation, which is allowable to the amalgamating company. The consideration paid by the taxpayer for acquiring the shareholding of the subsidiary in the earlier years is not relevant to the issue of depreciation on the assets taken under amalgamation and for the purpose of the fifth proviso to Section 32(1) of the Income-tax Act, 1961 (the Act).

The Tribunal observed that the decision of the Supreme Court in the case of Smiff Securities Ltd.<sup>2</sup> is only on the point whether the goodwill falls in the category of intangible assets or any other business or commercial rights of a similar nature as per the provisions of Section 32(1) of the Act. There is no disagreement on the issue that goodwill is eligible for depreciation. However, the Supreme Court decision would not override the provisions of Section 32(1) of the Act, which restricts the claim in the specified cases.

### Facts of the case

- The taxpayer is in the business of the production and sale of beer. During the relevant year, the taxpayer's subsidiaries namely Karnataka Breweries & Distillery Ltd. (KBDL), London Draft Pubs Pvt. Ltd. (LDPPL) and London Pilsner Breweries Pvt. Ltd. (LPBPL) were amalgamated with the taxpayer. The taxpayer claimed depreciation on goodwill, which was shown on account of the merger / amalgamation of KBDL.
- The Assessing Officer (AO) questioned the taxpayer about how this goodwill was added to the fixed assets. The taxpayer submitted that as per the order of the High Court, KBDL became a wholly-owned subsidiary of the taxpayer in the preceding year by virtue of the acquisition of shares of the said company from shareholders. The goodwill arose due to the acquiring of KBDL for a purchase consideration exceeding the fair value of tangible assets and other net current assets.
- Further, while considering the tangible assets i.e. land, building/s, plant/s, and machinery in its books, the Fair Market Value (FMV) was recorded. The taxpayer has also produced the valuation report of the valuer, who computed the FMV of the tangible assets based on replacement method and after reducing the depreciation from it, the FMV has arrived. Thus, the difference between the fair value and consideration was shown as goodwill.

<sup>1</sup> United Breweries Ltd. v. ACIT [ITA No. 722/Bang/2014, AY 2007-08] – Taxsutra.com

<sup>2</sup> CIT v. Smiff Securities Ltd. [2012] 348 ITR 302 (SC)

- The AO observed that the instead of the fair value of the assets based on the replacement value of the asset adopted in the valuation report, the FMV of assets should have been adopted in the books of accounts and consequently, the valuation of the goodwill would be reduced. Also, on the land valuation, the valuer has adopted the guidance rate without considering the sale incidents of comparable land. Thus, the AO observed that if the replacement of cost of building, plant and machinery and the higher value of land were taken to the books, there would not be any goodwill.
- The AO concluded that the differential amount being shown as goodwill cannot be considered as an amount paid for brewing license as the taxpayer has not got the valuation of the license. Accordingly, the AO disallowed the depreciation on the goodwill on the ground that there is no goodwill if the proper valuation is assigned to the tangible asset and land.
- On appeal, the Commissioner of Income-tax (Appeals) concurred with the decision of the AO.

### Tribunal's ruling

- A perusal of the Explanation 3 to Section 43(1) indicates that if the AO is satisfied that the main purpose of the transfer of such assets was the reduction of liability to income tax by claiming depreciation on the enhanced cost, the actual cost to the taxpayer shall be determined by the AO.
- In the present case, since there is an amalgamation of the subsidiary with the taxpayer, therefore, all the assets, which came to the taxpayer, are already in use by the subsidiary. Consequently, the valuation of all the assets is subjected to the verification of the AO as per Explanation 3 of Section 43(1) of the Act.
- However, the AO chose to examine the valuation of goodwill alone in order to disallow the claim of depreciation on the enhanced value of goodwill. The AO has not adopted any prescribed or well accepted method for valuation or actual cost of the goodwill in the hands of the taxpayer but he has doubted the valuation of the tangible assets and was of the view that the taxpayer has deflated the valuation of the tangible assets by the method of cost of replacement instead of FMV.
- The scope and objective of the Explanation 3 of Section 43(1) of the Act is to check the excess claim of depreciation by enhancing the cost of assets acquired, which were already in use by other person. Therefore, in the case of valuation of goodwill, the AO ought to have examined the valuation of all the assets taken over by the taxpayer under the amalgamation and thereby to determine the actual cost to the taxpayer for the purpose of the claim of depreciation.
- The value of the goodwill was shown in the books of the KBDL at INR74.5 million, which has been enhanced in the books of accounts of the taxpayer to INR623 million.
- The taxpayer contended that the AO cannot disturb the valuation of the goodwill when it is a differential amount between the consideration and the FMV of the tangible assets. The Tribunal held that if such claim of goodwill and depreciation were allowed, it would render the provisions of Explanation 3 to Section 43(1) of the Act redundant; otherwise, in every case of transfer, succession or amalgamation the party would claim excessive depreciation by assigning an arbitrary value to the goodwill.
- Therefore, the entire assets taken over by the taxpayer under the amalgamation are subjected to the Explanation 3 of Section 43(1) of the Act. Also, if the AO finds that the taxpayer has claimed excess claim of depreciation by enhancing the cost of goodwill then the actual cost of goodwill can be determined only by considering the actual cost of the other assets so acquired under amalgamation.
- There is another aspect involved in this issue of claiming depreciation on the enhanced cost of goodwill in cases of succession/ amalgamation, as it is restricted in the hands of a successor or amalgamated company only to the extent as apportioned between the amalgamating and amalgamated company in the ratio of number of days for which the assets are used by them.
- Further, the deduction shall be calculated at the prescribed rate as if the amalgamation has not taken place. The proviso to Section 32(1) of the Act provides that depreciation allowable in the case of succession, amalgamation or merger, demerger should not exceed the depreciation allowable had the succession not taken place. In other words, the allowance of depreciation to the successor/amalgamated

company in the year of amalgamation would be on the written down value of the assets in the books of the amalgamating company and not on the cost as recorded in the books of the amalgamated company.

- The case of amalgamation is not regarded as transfer for the purpose of capital gain as provided under Section 47(vi) of the Act and therefore such cases are exempted from capital gain, which is otherwise chargeable to tax on the transfer of assets.
- In the present case, the business of the subsidiary was transferred to the taxpayer by way of amalgamation, therefore; it would not be regarded as a transfer of an asset for the purpose of capital gain. Hence, the claim of depreciation on the assets acquired under the scheme of amalgamation is restricted only to the extent if such an amalgamation has not taken place.
- However, the AO has proceeded to hold the value of the goodwill as shown by the taxpayer is not justified. It is pertinent to note that once the claim of depreciation is restricted under the fifth proviso to Section 32(1)(ii), then the valuation issue become irrelevant.
- It is not the case of the taxpayer that the subsidiary has claimed any depreciation of goodwill. Therefore, by virtue of the fifth proviso to Section 32(1), the depreciation on the hands of the taxpayer is allowable only to the extent as if such succession has not taken place.
- Therefore, the taxpayer being amalgamated company cannot claim or be allowed depreciation on the assets acquired in the scheme of amalgamation more than the depreciation which is allowable to the amalgamating company.
- The decision of the Supreme Court in the case of Smiff Securities Ltd. is only on the point whether the goodwill falls in the category of intangible assets or any other business or commercial rights of similar nature as per the provisions of Section 32(1) of the Act. Therefore, there is no disagreement on the issue that goodwill is eligible for depreciation. However, the Supreme Court decision would not override the provisions of the fifth proviso to Section 32(1) of the Act, which restricts the claim in the cases specified thereunder.

- The consideration paid by the taxpayer for acquiring the shareholding of the subsidiary in the earlier years is not relevant to the issue of depreciation on the assets taken under amalgamation and for the purpose of the fifth proviso to Section 32(1) of the Act. Accordingly, the claim of depreciation in the hands of the taxpayer is subjected to the fifth proviso to Section 32(1) of the Act.

### Our comments

In the present case, the Tribunal held that if the taxpayer has claimed excess claim of depreciation by enhancing the cost of goodwill then the actual cost of goodwill can be determined only by considering the actual cost of the other assets so acquired under the amalgamation. Further, the deduction shall be calculated at the prescribed rate as if the amalgamation has not taken place. Also, once the claim of depreciation is restricted under the fifth proviso to Section 32(1)(ii) of the Act, then the valuation issue becomes irrelevant. Consequently, the amalgamated company cannot claim depreciation on the goodwill generated during the amalgamation process, wherein the amalgamation was through the acquisition of shares of the said company from shareholders.

The Tribunal while referring to the decision of the Supreme Court in the case of Smiff Securities Ltd. observed that the Supreme Court dealt with the question whether the goodwill falls in the category of intangible assets or any other business or commercial rights of similar nature as per the provisions of Section 32(1) of the Act. Further, the Supreme Court decision would not override the provisions of the fifth proviso to Section 32(1), which restricts the claim in the cases specified thereunder.

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